No. 13,220

IN THE

United States Court of Appeals

For the Ninth Circuit

CARMELO J. PELLEGRINO,
Appellant,

vs.

WILLIAM D. NESBIT, HUGH F. COLVIN, JAMES R. BRADBURN and CONSOLIDATED ENGINEERING CORPORATION,
Appellees.

MEMORANDUM FOR THE SECURITIES AND EXCHANGE COMMISSION, AMICUS CURIAE.

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Topical Index

Table of Authorities Cited

Cases

Statutes

Miscellaneous

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STATEMENT.

This is an appeal from a final order of the District Court of the United States for the Southern District of California, entered November 29, 1951, in which the court denied the motion of the appellant for leave to intervene in a suit brought pursuant to Section 16(b) of the Securities Exchange Act of 1934 (15 U.S.C. 78p(b)). Exclusive jurisdiction over such actions is conferred upon the district court by Section 27 of the Securities Exchange Act (15 U.S.C. 78aa). The Commission, as the agency of the Government

charged by the Congress with the administration of that Act, files this memorandum as *amicus curiae,* with the Court's permission, in order to inform the Court of its views upon the issues of construction of the Act raised by the pleadings. The Commission likewise participated as *amicus curiae* below.

FACTS.

Carmelo J. Pellegrino is a minority stockholder of Consolidated Engineering Corporation. On October 2, 1950, he requested the company to institute an action pursuant to Section 16(b) of the Securities Exchange Act[1] against William D. Nesbit, Hugh F. Col-

[1]Section 16(b) provides:

"For the purpose of preventing the unfair use of information which may have been obtained by such beneficial owner, director, or officer by reason of his relationship to the issuer, any profit realized by him from any purchase and sale, or any sale and purchase, of any equity security of such issuer (other than an exempted security) within any period of less than six months, unless such security was acquired in good faith in connection with a debt previously contracted, shall inure to and be recoverable by the issuer, irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not repurchasing the security sold for a period exceeding six months. Suit to recover such profit may be instituted at law or in equity in any court of competent jurisdiction by the issuer, or by the owner of any security of the issuer in the name and in behalf of the issuer if the issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter; but no such suit shall be brought more than two years after the date such profit was realized. This subsection shall not be construed to cover any transaction where such beneficial owner was not such both at the time of the purchase and sale, or the sale and purchase, of the security involved, or any transaction or transactions which the Commission by rules and regulations may exempt as not comprehended within the purpose of this subsection."

vin and James R. Bradburn, officers of the company, in order to recover profits realized by them from purchases and sales of the company's securities within a six-month period.

Prompted by this request, the company filed a complaint against each of these officers (R. 3, 27, 50). Similar answers filed by each of the defendants raised, *inter alia,* the defense that the corporation was estopped to bring the action because the purchases had been made under option agreements entered into between the corporation and the defendants. It was alleged that the defendants had made their purchases and sales "in reliance upon plaintiff's assurance that plaintiff claimed no interest in any profits arising from said transactions" (R. 10, 34, 58).

A pre-trial stipulation was filed in each case in which it was agreed that the option agreements were part of a series of such agreements between the plaintiff and 16 key employees, granted to the employees in order to encourage them to remain in the employ of the plaintiff at a salary the plaintiff was able to pay. When the agreements, which provided for the purchase of the stock at $5 per share, were executed, the market price of the stock was less than $5. The sales, however, were made at prices substantially higher.

Following the pre-trial stipulation, the court below heard argument upon the issues of law, the three actions being consolidated. It then ruled that the corporation was estopped "to recover profits of a

transaction which the corporation itself initiated and set up and which it (at least inferentially) assured defendants was valid" (R. 81). Judgment was entered in favor of the defendants.

The company decided not to take any appeal in any of the three cases. Pellegrino, therefore, applied to the court below for leave to intervene in order to appeal in behalf of the company. The court below denied this application. This appeal is taken from that order of denial.

QUESTION INVOLVED.

Did the court below err in denying timely application by the appellant for leave to intervene for the purpose of taking appeals from judgments of the District Court in favor of officers of the corporation in actions brought by the corporation pursuant to Section 16(b) of the Securities Exchange Act, where it appeared that the corporation had decided not to appeal from the judgments despite the existence of substantial issues of law?

ARGUMENT.

Section 16(b) was adopted after an extensive Congressional investigation which disclosed repeated instances in which insiders took advantage of confidential information by trading upon it prior to its

public disclosures.[2] In order to discourage such activities the section provides that all profits realized from such trading shall inure to the corporation. As the instrument to enforce this statutory policy, the Congress selected the corporation itself. However, in recognition of the reluctance some corporations might feel toward assuming the obligation to bring an action against their own directors, officers and large stockholders, it is provided that if the corporation refuses to bring the action "or shall fail diligently to prosecute the same" any security holder may undertake it.

Thus the section itself provides for participation by security holders when the corporation falters in the prosecution of an action. Consolidated Engineering Corporation, after being advised by the plaintiff herein of the liability of the defendants and, presumably, being aware of his readiness to institute the actions if the corporation did not, initiated the proceedings. However, it abandoned them when adverse decisions were rendered by the District Court.

It is clear from the opinion rendered by the District Court—if not from the very participation of the Commission as *amicus curiae*—that the issues resolved by that court were substantial. Indeed, the District Court's rulings in these cases represented the first instance in which any court has held a corporation to be estopped from enforcing the sanctions imposed upon insiders who have traded in their company's

[2]See Report No. 1455 of the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. (1934) 55-68. On Section 16(b) in general, see Loss, *Securities Regulation* (1951) 561-98.

securities, and another District Court has since come out the other way as we shall see in a moment.

The opinion is based, primarily, upon the absence of any proof that there had been any improper use of inside information, and upon what the court labelled an "inequity" in the statute if defendants should be held liable despite the non-liability of the other 13 employees who received the benefits of the option agreements but who were not officers, directors or large stockholders (R. 89, 98, 106).[3]

As one of the draftsmen of the Act testified during the hearings preceding its adoption, Section 16(b) is designed to reach profits realized by insiders as a result of short-term trading "irrespective of any intention or expectation to sell the security within six months," for it is "absolutely impossible to prove the existence of such intention or expectation, and you have to have this crude rule of thumb, because you cannot undertake the burden of having to prove that the director intended, at the time he bought, to get out on a short swing."[4] The section itself provides that the liabilities thereunder shall be imposed "irrespective of any intention on the part of such beneficial owner, director, or officer in entering into such transaction of holding the security purchased or of not

[3]Although the section specifically refers to actions "at law or in equity" to enforce its provisions, the court chose to consider the action "an equitable proceeding," mistakenly assuming that the Commission so considered it, and applied "equitable doctrines coextensive with the common law" to modify the "hard rule of law" it felt might otherwise be indicated by the statute (R. 83).

[4]Hearings before the Senate Committee on Banking and Currency on S. 84, 73rd Cong., 1st Sess. (1934) 6557.

repurchasing the security sold for a period exceeding six months."

Under this provision it has never been deemed relevant to inquire into the mental state of the insider in those cases which have imposed liability, and proof of injury to either the security holders of the corporation or the corporation is not an element of the action. *Smolowe v. Delendo Corp.,* 136 F. 2d 231 (C.A. 2), cert. denied, 320 U.S. 751; *Park & Tilford, Inc. v. Schulte,* 160 F. 2d 984 (C.A. 2), cert. denied, 332 U.S. 761; *Gratz v. Claughton,* 187 F. 2d 46 (C.A. 2), cert. denied, 341 U.S. 920. In a sense, this is but the specific application of the time-honored doctrine that a trustee may engage in no activity which may, by even a remote possibility, involve a conflict of interest between his official duty and his private interest. *Michaud v. Girod,* 4 How. 503, 559; *Magruder v. Drury,* 235 U.S. 106; *Pepper v. Litton,* 308 U.S. 295. At any rate, the intent and command of the Congress require liability to be imposed regardless of the presence or the absence of good faith, and in spite of any feeling held by the District Court with regard to the ultimate equities of the situation.

The existence of other optionees who do not belong to the class of persons the Congress has restricted in Section 16(b) offers little basis for so construing the section as to remove the three "insiders" from the scope of the section. The classification of insiders as persons who would be likely to have access to inside information appears to be not only reasonable, but

fully accepted by the common law of fiduciary responsibility.[5]

But, even if it be assumed that some affirmative representation by the corporation or its directors or officers may be implied to the effect that Nesbit, Colvin and Bradburn would be free immediately to sell the shares acquired by them pursuant to the option, such a representation could not affect their liabilities under the Act.

The corporation and its security holders are but instruments to vindicate the statutory policy against short-term trading by insiders. There is no necessary relationship between any loss suffered by the corporation by virtue of the trading and the amount of the recovery.[6] The section simply seeks to discourage insiders from short-term trading by forcing them to give up any profits realized from such activities. Clearly, the legislative purpose would be thwarted if the corporation could waive or estop itself by some action. Indeed, even if every security holder expressly waived his right of action under the section, we do not believe one of them would be precluded from later disavowing his waiver and bringing the action. Certainly in the absence of a unanimous waiver by all security holders there can be no bar.

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[5]See *Gratz v. Claughton,* 187 F. 2d 146 (C.A. 2), cert. denied, 341 U.S. 920.

[6]*Cf. In the Matter of William F. Davis, Jr.,* 17 T.C. 59 and *In the Matter of William L. Dempsey,* 17 T.C. (Sept. 28, 1951), where the Tax Court considered the payment to the corporation in the nature of a penalty to enforce the statutory policy. *Cf.* also *Brophy v. Cities Service Co.,* 70 A. 2d 5 (Del. Ch.).

This is all the more clear in view of Section 29(a) of the Act (15 U.S.C. 78cc(a)), which specifically provides:

> "Any condition, stipulation, or provision binding any person to waive compliance with any provision of this title shall be void."

Since the corporation could not be estopped by an express waiver, an implied waiver should likewise be void.[7] The non-waiver provision of Section 29(a) is applicable to the Act as a whole, but it is particularly appropriate in the context of the liability imposed by Section 16(b), for in such actions the management may be in substance both plaintiff and defendant. This was recognized in the recent decision of the District Court for the Southern District of New York in *Blau v. Hodgkinson,* 100 F. Supp. 361, where it was held that even an agreement of settlement of a Section 16(b) claim executed by the corporation

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[7] *Cf. Kaiser Frazer Corp. v. Otis & Co.,* ..... F. 2d ..... (C.A. 2, Apr. 7, 1952), in which the court stated, with reference to a similar no-waiver provision in the Securities Act:

> "But whatever the rules of estoppel or waiver may be in the case of an ordinary contract of sale, nevertheless it is clear that a contract which violates the laws of the United States and contravenes the public policy as expressed in those laws is unenforceable. Further support for our holding may be found in § 14 of the Act of 1933, 15 U.S.C.A. § 77n, which provides as follows: 'Any condition, stipulation, or provision binding any person acquiring any security to waive compliance with any provision of this subchapter or of the rules and regulations of the Commission shall be void.' The broad language of this section may be construed to brush aside ordinary contract principles of estoppel and waiver that might otherwise apply to contracts for securities, including underwriting agreements."

and the officer who did the trading did not bar a subsequent suit upon the same cause of action.

The District Court for the Eastern District of Louisiana, in an opinion rendered April 2, 1952, was presented with a similar issue. It was there argued, as in the case at bar, that the action of the corporation in granting one of its officers an option to buy stock estopped it from suing the officer to recover his profits from subsequent sales under Section 16(b). The court held:

> "This argument ignores the fact that it is not the exercise of the option which is penalized under Section 16(b). If this defendant had not sold stock of his corporation within six months after he acquired the option stock then of course Section 16(b) would not apply. Defendant further argues, however, that when the corporation voted defendant the option to acquire the stock it was intended that he sell on the short swing in order that he might make a profit and thereby be compensated for meritorious service to the corporation. Consequently, so the argument goes, the corporation cannot now demand the profits from transactions it implicitly approved.
>
> "This argument misconceives the purpose of Section 16(b). Section 16(b) became law following a Congressional investigation which showed unhealthy, if not unconscionable, dealings between officers and directors of a corporation and the corporation itself, some of which dealings involved options from the corporation to the officers and directors. One of the purposes of Section 16(b) was to prevent these questionable transactions

between insiders among themselves to the possible detriment of the minority shareholders and the public in general. It is true that Section 16(b) makes short-term profits by officers and directors inure to the corporation and provides that the corporation shall institute proper proceedings to claim these profits. The bringing of such suit by the corporation, however, cannot work out an estoppel. The statute directs the corporation to bring the suit and, realizing that corporations where insiders deal in its stock on the short swing are very often under the control of those insiders and consequently may be loath to bring such suits or having brought them to prosecute them actively, provides further that any shareholder may bring the suit in the name of the corporation where the corporation has not acted. The courts, also as a protective measure, have allowed shareholders to intervene freely where the corporation has brought suit pursuant to Section 16(b). Park & Tilford v. Schulte, 160 F. 2d 984 (CCA-2-1947). In other words, in order to protect minority shareholders and the public who have no control over the management of the corporation, Section 16(b) uses the corporation as an instrument, sometimes an unwilling instrument, by which the officer or director is forced to disgorge his short term profits. Under such circumstances there can be no estoppel." *Jefferson Lake Sulphur Co. v. Walet,* ..... F. Supp. ..... (E.D. La., Apr. 2, 1952).

It is, of course, a legitimate management function to determine whether or not an action should be further pursued by an appeal. But the decision taken is subject, in actions brought pursuant to Section

16(b), to the statutory admonition that if the management fails diligently to prosecute a claim any security holder may undertake it. Here management expressly declined to take an appeal, although important and novel questions of law were involved. Certainly management's decision constituted a failure to prosecute diligently within the meaning of the section, and any security holder should have been permitted to assume the responsibility for carrying the litigation forward.[8]

Even if we assume the utmost good faith on the part of management in reaching its decision not to continue the prosecution, it would manifestly permit ready evasion of statutory safeguards against complete control by corporate management of suits against other members of management pursuant to Section 16(b) if the corporate management could thus preclude security holder action.

Hitherto the courts have freely granted to security holders the right to intervene in Section 16(b) actions—both by virtue of the section itself, which, as we have shown, contemplates a liberal grant of this right, and by virtue of Rule 24(a)(2) of the Federal Rules of Civil Procedure, which allows intervention as a matter of right whenever "the representation of applicants' interest by existing parties is or may be

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[8]See *Young v. Higbee Co.*, 325 U.S. 204, where the Court emphasized the fiduciary nature of the relationship between the appellants and the class they presumed to represent, and denied to the appellants, who had sold their interest in the corporation which was the subject of the appeal and withdrawn their appeal, the fruit of their sale.

inadequate."[9] The Court of Appeals for the Second Circuit, in reversing an order which denied a stockholder's application to intervene in an action brought pursuant to Section 16(b) by the corporation, pointed out that stockholder participation in such actions should be welcomed "to guard against even the appearance of any concerted action." It was pointed out, further, that unless such participation was allowed "the interests of minority security holders [might not be] adequately represented."[10]

Indeed, merely the existence of important and novel questions of law, when the facts are undisputed, raises sufficient doubt of the adequacy of the representation of the minority stockholders to justify intervention. *Twentieth Century-Fox Film Corp. v. Jenkins,* 7 F.R.D. 197 (S.D. N.Y.).

It has even been held that a security holder should be permitted to intervene in a Section 16(b) action although "the case . . . presently appears to present no real issues." *Berkey & Gay Furniture Co. v. Wigmore,* CCH Fed. Sec. L. Serv. par. 90,376 (S.D. N.Y.).

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[9]This rule has consistently been construed to permit intervention freely. See *e.g., U.S. v. C.N. Lifeboat Co., Inc.,* 25 F. Supp. 410 (E.D. N.Y.), affirmed, 118 F. 2d 793 (C.A. 2), appeal dismissed, 314 U.S. 579, where it was held that the petitioner's representation was inadequate because he was not on friendly terms with the attorney for the defendant, who presumed to be representing his interest; *Plye-National Co. v. Amos,* 172 F. 2d 425 (C.A. 7), where a stockholder was permitted to intervene in a suit by the corporation against former officers of the corporation.

[10]*Park & Tilford v. Schulte,* 160 F. 2d 984, 988 (C.A. 2).

The many opportunities for less than vigorous prosecution in the course of litigation, the amicable nature of many section 16(b) claims by a corporation against its own "insiders," the conflict of interests in some such cases which it is difficult to show, and the public interest in the enforcement of the sanctions require free intervention by minority interests. "No possible prejudice can result from the intervention, whereas the same may be beneficial to the corporation and its stockholders."[11]

CONCLUSION.

For the reasons stated, we believe the order of the court below denying the appellant the right to intervene should be reversed.

Dated, May 9, 1952.

Respectfully submitted,

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[11] *American Distilling Co. v. Brown*, 112 N.Y.L.J. 261 (Sup. Ct. 1944).